IT 06-7
Tax Type: Income Tax
Issue: Federal Preemption

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	
v.	**Docket # 05-IT-0000** **FEIN 00-0000000**
ABC OF FINANCIAL INSTITUTIONS **Taxpayer**	**Claim for Credit or Refund**

RECOMMENDATION FOR DISPOSITION

Appearances: Kent Steinkamp, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Creighton R. Castle of Giffin, Winning, Cohen & Bodewes, P.C. for ABC of Financial Institutions.

Synopsis:

This case concerns whether the Illinois tax on unrelated business taxable income ("UBTI") (35 ILCS 5/205(a)) is preempted by section 514(a) of the Employee Retirement Income Security Act ("ERISA") (29 U.S.C. §1144(a)). The ABC of Financial Institutions ("taxpayer") is exempt from federal income tax under section 501(c)(9) of the Internal Revenue Code ("Code"). The taxpayer filed a Form IL-990-T with the Department of Revenue ("Department") for each of the years ending March 31, 2000, 2001, and 2002 showing UBTI. The taxpayer subsequently filed a Form IL-843, Amended Return or Notice of Change in Income, for each of the years 2000, 2001, and 2002. These forms requested refunds totaling $177,051. The Department issued a Notice of Denial that denied the taxpayer's refund requests, and the taxpayer timely protested the Department's decision. The taxpayer argues that it is entitled to the refunds because the tax on unrelated business income is pre-empted by ERISA. The parties waived their right to an evidentiary hearing and filed a Stipulation of Facts with supporting documents and briefs. The parties have requested that this matter be resolved based on the documents that were filed. After reviewing the evidence presented, it is recommended that this case be resolved in favor of the Department.

FINDINGS OF FACT:

1. The taxpayer is a separate legal entity and the policyholder for the various group insurance policies offered to all of the taxpayer's members. (Stip. #9)
2. The taxpayer provides health and dental benefits covering employees of the taxpayer's members. (Stip. #10)
3. The taxpayer is a medium by which its members can provide life, accident, health, dental, vision and disability coverage for the member's employees. (Stip. #11)
4. The taxpayer has a minimum premium funding contract with an insurance carrier which allows the taxpayer to hold a substantial portion of the contributions collected from its members, and also to pay benefits directly to the insureds using a third party claims administrator. (Stip. #12)
5. The taxpayer pays health benefits up to a specified dollar limit, plus a premium stabilization reserve. (Stip. #13)

6. Any amounts paid by the taxpayer in excess of the limit, including the premium stabilization reserve, are reimbursed by the insurance carrier. (Stip. #14)
7. The taxpayer's contract with the insurance carrier provides for the taxpayer to maintain a premium stabilization reserve to be funded from "excess plan contributions and excess premiums." (Stip. #15)
8. The insurance carrier determines the amount of the premium stabilization reserve at the end of each fiscal year. (Stip. #16)
9. The premium stabilization reserve is callable by the insurance carrier in order to fund deficits, if any, which result from the coverages provided in future years, and to pay for claims existing at the termination of the contract. (Stip. #17)
10. Life, accidental death and dismemberment, and long-term disability coverages are provided directly by the insurance carrier. (Stip. #18)
11. The taxpayer is exempt from taxation under Section 501(c)(9) of the Internal Revenue Code. (Stip. #19)
12. The taxpayer is subject to the provisions of Code Section 512(a)(3)(E). (Stip. #20)
13. The taxpayer is an employee welfare benefit plan subject to ERISA's provisions as it is a fund which provides for its participants or beneficiaries through purchase or otherwise, medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability or death. (Stip. #21)
14. The exceptions to ERISA compliance under ERISA Sections 4(b), 201, 301, and 401 are not applicable to the taxpayer. (Stip. #22)
15. The taxpayer is subject to the provisions of ERISA. (Stip. #23)

16. For the taxpayer's tax years ending March 31, 2000, March 31, 2001, and March 31, 2002, the taxpayer filed Form IL-990-T (Illinois Exempt Organization Income and Replacement Tax Return) showing UBTI of $326,956, $381,032, and $3,266,210 respectively. (Stip. #24, 25, 26; Ex. A, B, C)
17. On August 14, 2003, the taxpayer filed Form IL-843 (Amended Return or Notice of Change in Income) for the year ending March 31, 2000 requesting a refund of $14,566. (Stip. #27; Ex. D)
18. On September 2, 2003, the taxpayer filed two Forms IL-843: one for the year ending March 31, 2001 requesting a refund of $16,975, and one for the year ending March 31, 2002 requesting a refund of $145,510. (Stip. #28, 29; Ex. E, F)
19. The amended returns were all timely filed with the Department within the meaning of Section 911(a) of the Illinois Income Tax Act ("Act"). (Stip. #30)
20. The exemption to Code Section 512(a)(3)(E) under Code Section 512(a)(3)(E)(iii) is not applicable to the taxpayer as the employers making contributions to the taxpayer are not exempt from tax under Chapter 1 of the Code. (Stip. #38)

<u>CONCLUSIONS OF LAW</u>:

Section 205(a) of the Illinois Income Tax Act provides as follows:

Charitable, etc. organizations. The base income of an organization which is exempt from the federal income tax by reason of Section 501(a) of the Internal Revenue Code shall not be determined under section 203 of this Act, but shall be its unrelated business taxable income as determined under section 512 of the Internal Revenue Code, without any deduction for the tax imposed by this Act. The standard exemption provided by section 204 of this Act shall not be allowed in determining the net income of an organization to which this subsection applies. 35 ILCS 5/205(a).

The purpose of this tax on unrelated business income is identical to the purpose of its federal counterpart, which is to prevent tax-exempt organizations from competing unfairly with businesses whose earnings are taxed. See United States v. American Bar Endowment, 477 U. S. 105, 114 (1986). The taxpayer contends that this section is pre-empted by §514(a) of ERISA to the extent that the tax applies to ERISA plans.

It must initially be noted that in fields traditionally regulated by the States, it is assumed that the historic police powers of the States are not superseded by a Federal Act unless that was the clear and manifest purpose of Congress. New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Company, 514 U. S. 645, 654-655 (1995). When a law operates in an area that has been traditionally occupied by the States, the party alleging pre-emption has the burden of overcoming the presumption that Congress did not intend to pre-empt state law. *Id*., (claims of pre-emption are addressed with the starting presumption that Congress does not intend to supplant state law).

ERISA's pre-emption provision in §514(a) states that ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan" covered by ERISA. 29 U.S.C. §1144(a). The Supreme Court in Shaw v. Delta Air Lines, Inc., 463 U. S. 85 (1983), explained the term "relate to" by referring to its dictionary definition and stated that a law "relates to" an employee benefit plan if it has a (1) connection with or (2) reference to such a plan. *Id*. at 96-97. The court cautioned, however, that pre-emption does not occur if the state law has only a "tenuous, remote, or peripheral" connection with the covered plans. *Id*. at 100, n. 21. The Supreme Court subsequently rejected an expansive reading of the "relate to" language, stating that "[i]f 'relate to' were taken to extend to the furthest stretch of its indeterminacy, then for all practical purposes pre-emption would never run its course, for really, universally, relations stop nowhere." Travelers, *supra*, at 655 (internal quotation marks and citation omitted).

Under the Supreme Court's two-part inquiry, it has indicated that a law has an impermissible "reference to" a plan when it acts immediately and exclusively upon an ERISA plan, or where the existence of an ERISA plan is essential to the law's operation. California Division of Labor Standards Enforcement v. Dillingham Construction, N.A., Inc., 519 U. S. 316, 325 (1997). Pre-emption resulted when the court found that a state law expressly referred to and solely applied to ERISA plans. See Mackey v. Lanier Collection Agency & Service, Inc., 486 U. S. 825, 830 (1988) (statute that expressly prohibited garnishment of ERISA plan funds was pre-empted). ERISA prevailed when the court found that a common law cause of action referred to and was premised on the existence of a pension plan. See Ingersoll-Rand Company v. McClendon, 498 U. S. 133, 140 (1990) (plaintiff's claim that employer wrongfully terminated him based on the employer's desire to avoid paying into the employee's pension plan was pre-empted). In addition, the court found that a state law that imposed requirements by reference to a covered plan must yield to ERISA. See District of Columbia v. Greater Washington Board of Trade, 506 U. S. 125, 130-131 (1992) (law requiring employers who provide health insurance for their employees to provide "coverage equivalent to the existing health insurance coverage" while the employee receives workers' compensation benefits was pre-empted).

If the law does not "refer to" ERISA plans, it may still be pre-empted if it has a "connection with" ERISA plans. Under this analysis, the court stated that "[f]or the same reasons that infinite relations cannot be the measure of pre-emption, neither can infinite connections." Travelers, *supra*, at 656. "To determine whether a state law has the forbidden connection, we look both to 'the objectives of the ERISA statute as a guide to the scope of the state law that Congress understood would survive,' as well as to the nature of the effect of the state law on ERISA plans." California Division of Labor Standards Enforcement v. Dillingham Construction, N. A., Inc., 519 U. S. 316, 325 (1997) (quoting Travelers, *supra* at 656).

Under this inquiry, the court found that ERISA pre-empted a law that eliminated a method for calculating pension benefits that was permitted by federal law. See Alessi v. Raybestos-Manhattan, Inc., 451 U. S. 504, 524 (1981) (state law prohibiting the offset of workers' compensation benefits against pension benefits was pre-empted). A similar finding was made in a case where the court stated that a law is pre-empted with respect to ERISA plans insofar as it prohibits practices that are lawful under federal law. See Shaw, *supra*, at 108-109 (state law forbidding discrimination in employee benefit plans on the basis of pregnancy was pre-empted). The court has also found that ERISA prevails when a state law mandates the administration or structure of benefits. See FMC Corporation v. Holliday, 498 U. S. 52, 60 (1990) (state law that prohibited ERISA plans from requiring reimbursement from the beneficiary in the event of recovery from a third party was pre-empted). In addition, the court found that ERISA pre-empted a statute that bound plan administrators to a particular choice of rules for determining beneficiary status. See Egelhoff v. Egelhoff, 532 U. S. 141, 147 (2001) (statute that automatically revoked upon divorce the designation of a spouse as the beneficiary of a non-probate asset such as an ERISA plan was pre-empted).

The taxpayer argues that Illinois' unrelated business income tax ("UBIT") is pre-empted by ERISA because it both refers to ERISA plans and has a connection with ERISA plans. The taxpayer states that the UBIT provision refers to Code §501(a), which references Code §501(c) entities such as the taxpayer. The taxpayer also cites §100.2470(h)(4) of the Department's regulations concerning income tax, which provides as follows:

> h) Income not exempt from Illinois income taxation. The following types of income are not exempt from Illinois income taxation:
>
> * * *
>
> 4) Section 514(a) of the Employee Retirement Income Security Act of 1974 (ERISA, 29 USC 1144(a)) does not preempt the taxation of unrelated business income of an Employee Benefit Plan governed by ERISA. Buono v. NYSA-ILA Medical and Clinical Services Fund, 520 U.S. 806, 808 (1997). Taxpayers that relied upon the Department's letter rulings IT 90-0073, IT 93-0017 and IT 93-0187, prior to July 1, 2002, shall not incur liability for taxes or penalties pursuant to Section 4(c) of the Taxpayers' Bill of Rights Act [20 ILCS 2520]. 86 Ill.Admin.Code, ch. 1, §100.2470(h)(4).

According to the taxpayer, the regulation specifically refers to ERISA plans, and therefore is pre-empted by ERISA. The taxpayer claims that this places the UBIT in a field of exclusive federal concern, which is the field of pension and benefit plans.

The taxpayer argues that this case is similar to Greater Washington Board of Trade, *supra*, because the Illinois law specifically refers to ERISA entities as being subject to its imposition. The taxpayer asserts that the Illinois statute specifically refers to taxing an organization's UBTI as determined under Code §512, and Code §512(a)(3)(E) applies exclusively to ERISA plans.[1] In the taxpayer's view, the Illinois

1 Code §512 concerns unrelated business taxable income. See 26 U.S.C. §512.

statute impermissibly refers to ERISA plans because it incorporates Code §512(a)(3)(E).2 The taxpayer contends that the Code §512(a)(3)(E) tax is not a tax of general applicability that applies to any entity's UBTI because entities may be exempt under §512(a)(3)(E)(iii).

The taxpayer also contends that the Illinois statute impermissibly has a connection with ERISA plans. The taxpayer claims that the law imposes substantial burdens on the taxpayer, and it subjects the taxpayer to reporting and compliance requirements. The taxpayer argues that it also impacts its investment strategies. According to the taxpayer, the Illinois tax reduces the funds available for the taxpayer and its member beneficiaries to pay plan beneficiary health, disability and life claims. The tax also gives rise to filing and payment duties, which involve estimation and timing issues. Because of this, the taxpayer claims that the law is connected with the ERISA plan in more than a remote, tenuous, or peripheral manner, which makes it pre-empted by ERISA.

The Department contends that in Travelers, the Supreme Court rejected the two-tier analysis for ERISA pre-emption, and instead adopted an analysis that focuses on the intent behind §514(a). The Department argues that the analysis provided in Travelers allows a state to legislate an indirect effect on ERISA plans if the law is one of general applicability and respects ERISA's goal of insuring national uniformity of benefit protections. The Department claims that its regulation was promulgated to indicate that the Supreme Court's position was effectively reversed.

The Department maintains that the Illinois law merely seeks to reach any income that the federal government reaches. The Department states that the UBIT is nothing

2 The taxpayer is subject to the provisions of §512(a)(3)(E), and the exemptions to §512(a)(3)(E) that are under §512(a)(3)(E)(iii) do not apply. (Stip. #20, 38)

more than a tax on certain income earned by a Code §501 exempt organization, and the tax is on the income that is earned by a business venture that is unrelated to the organization's exempt purposes. The Department believes that the Illinois legislature took the same approach as Congress and found that exempt entities should not have the advantage of tax-free earnings when they conduct regular businesses in the competitive atmosphere of the for-profit business environment. The Department contends that this tax places no burden on the ERISA plan itself because the taxed income is "unrelated" to the plan.

In response, the taxpayer claims the fact that Illinois piggybacked off the federal UBIT does not mean that Congress intended the states to enact similar measures. Rather, according to the taxpayer, Congress aimed to maximize the financial well-being of ERISA plans, and the Illinois tax is inapposite to this aim.

The taxpayer maintains that the Department's assertion that the Supreme Court rejected the two-tier analysis in Travelers is incorrect. The taxpayer notes that the Supreme Court applied the two-tier analysis in a case that was decided after Travelers. See Dillingham, *supra*. The taxpayer also asserts that §514(c) of ERISA indicates that state laws include regulations. The taxpayer therefore claims that the Department's regulation that expressly refers to employee benefit plans violates the ERISA pre-emption provision under the Supreme Court analysis.

As the taxpayer indicated, the Supreme Court has continued to apply the two-tier ERISA pre-emption analysis after its decision was rendered in Travelers. See *e.g.*, Dillingham, *supra*; Egelhoff, *supra*. There is no indication in Travelers that the Supreme Court has rejected this analysis. Instead, the court rejected an expansive reading of the words "relate to" and recognized that there must be limits to applying its analysis. In this regard, the court stated that in deciding whether a state law has an improper connection with an ERISA plan, both the objectives of the ERISA statute and the effect of the state law on ERISA plans must be considered. Travelers, *supra* at 656.

In Travelers, the court considered a New York statute that required hospitals to collect surcharges from patients covered by commercial insurers but not from patients insured by a Blue Cross/Blue Shield plan. Commercial insurers, acting as fiduciaries of ERISA plans that they administered, claimed the law was pre-empted. The Supreme Court initially determined that the law does not have a "reference to" ERISA plans because the surcharges were imposed regardless of whether the commercial coverage or membership was ultimately secured by an ERISA plan. *Id*.

The court then considered whether the surcharge laws had a "connection with" the ERISA plans. In determining whether there is a connection, the court stated that instead of simply looking at the definition of the term, it must look to "the objectives of the ERISA statute as a guide to the scope of the state law that Congress understood would survive." *Id*. The court noted that by enacting §514(a) of ERISA, Congress intended to ensure that plans and plan sponsors would be subject to a uniform body of benefits law. *Id*. The objective of the ERISA statute was to eliminate the threat of conflicting and inconsistent state and local regulation of employee benefit plans. In other words, the thrust of pre-emption is "to avoid a multiplicity of regulation in order to permit the nationally uniform administration of employee benefit plans." *Id*. at 657.

The court found that the purpose and effects of the New York statute distinguished it from the statutes in other cases where the laws were pre-empted. The court stated that the charge differentials in the state law were justified and made Blue Cross/Blue Shield a more attractive insurance alternative. The statute therefore had an indirect economic effect on choices made by insurance buyers, including ERISA plans. "An indirect economic influence, however, does not bind plan administrators to any particular choice and thus function as a regulation of an ERISA plan itself." *Id*. at 659. "[T]o read the pre-emption provision as displacing all state laws affecting costs and charges on the theory that they indirectly relate to ERISA plans * * * would effectively read the limiting language in §514(a) out of the statute." *Id*. at 661. The court added, "cost uniformity was almost certainly not an object of pre-emption." *Id*. at 662. Laws with only an indirect economic effect on the relative costs of various health insurance packages "do not bear the requisite 'connection with' ERISA plans to trigger pre-emption." *Id*.

The court concluded by saying, "we do not hold today that ERISA pre-empts only direct regulation of ERISA plans." *Id*. at 668. "We acknowledge that a state law might produce such acute, albeit indirect, economic effects, by intent or otherwise, as to force an ERISA plan to adopt a certain scheme of substantive coverage or effectively restrict its choice of insurers, and that such a state law might indeed be pre-empted under §514." *Id*. The New York statute at issue, however, did not fall into either category.

Another case in which the Supreme Court found that ERISA did not pre-empt the state law is <u>De Buono v. NYSA-ILA Medical and Clinical Services Fund</u>, 520 U. S. 806 (1997). In that case, a New York law imposed a gross receipts tax on the income of medical centers, which included centers operated by ERISA funds; the tax was implemented to reduce the State's Medicaid deficit. After considering the actual operation of the law, the court found that it was one of general applicability that imposed some burdens on the administration of ERISA plans, but did not "relate to" them within the meaning of §514. The court stated that the tax was on hospitals, and most hospitals are not owned or operated by ERISA funds. The court found that if the fund had not chosen to operate hospitals directly and had instead purchased services from a hospital, that facility would have passed on the expense of the tax through the rates it set for the services. Although in that circumstance the tax would be "indirect," its impact in all relevant respects would be identical to the "direct" impact of the tax paid by the fund itself. "Any state tax, or other law, that increases the cost of providing benefits to covered employees will have some effect on the administration of ERISA plans, but that simply cannot mean that every state law with such an effect is pre-empted by the federal statute." De Buono, *supra* at 816.

One more case where the Supreme Court found that the state law was not pre-empted is Dillingham, *supra*. In that case, the court considered California's prevailing wage law that prohibited payment of an apprentice wage to an apprentice who is trained in an unapproved program (i.e., the prevailing journeyman wage must be paid to apprentices from a non-approved program). The court found that the wage statute was similar to New York's surcharge program in Travelers because the apprenticeship portion of the prevailing wage statute did not bind ERISA plans to anything. Dillingham, *supra* at 332. The court found that the effect of the statute on ERISA apprenticeship programs was merely to provide economic incentive to comply with the State's requirements, at least to the extent that those programs want to provide apprentices who can work at the lower rate. *Id*. "The prevailing wage statute alters the incentives, but does not dictate the choices, facing ERISA plans." *Id*. at 334.

The taxpayer distinguishes Travelers and De Buono on the basis that the state laws in those cases applied in fields traditionally regulated by the states (health and safety), and the laws in those cases only indirectly increased the cost of the ERISA plan's operation. In De Buono, the tax was not on ERISA plans *per se*, but on health care facilities. In the present case, the taxpayer believes that the law imposes a tax on ERISA-covered organizations. Thus, according to the taxpayer, rather than operating in a field traditionally regulated by the states, the tax thrusts itself into a field (pension and benefit plans) of exclusive federal concern. The taxpayer contends that the Illinois law is simply a tax on ERISA plans, and the law is a revenue raising measure for the State of Illinois.

As a revenue raising measure, it cannot be said that the law operates in an area of traditional federal concern. Taxation is part of a state's traditional regulatory power. See Hattem v. Schwarzenegger, 449 F. 3d 423, 431 (2nd Cir. 2006) ("taxation is a realm of historic state control"). As previously noted, because the UBIT operates in an area traditionally regulated by the States, the taxpayer has the burden of overcoming the presumption that Congress did not intend to pre-empt the state law. See Travelers, *supra*.

The UBIT is a tax on the unrelated business income of all tax-exempt organizations and does not apply solely to the field of pension and benefit plans. The language of the UBIT provision does not explicitly refer to ERISA plans. The UBIT does not act "exclusively" upon ERISA plans. See Dillingham, *supra* at 325. It is not specifically aimed at ERISA plans, but operates in a manner that applies to all tax-exempt entities. The law applies regardless of the existence of an ERISA plan.

The UBIT is not similar to the laws that the Supreme Court found pre-empted on the basis that they had a reference to ERISA plans. The UBIT does not expressly refer to or solely apply to ERISA plans (see Mackey, *supra*), the law is not premised upon the existence of a plan (see Ingersoll-Rand, *supra*), and the statute does not impose requirements by reference to a plan (see Greater Washington Board of Trade, *supra*).

The Department's regulation that refers to ERISA simply clarifies the type of income that is not exempt from tax. An agency may develop guidelines to aid in statutory interpretation by promulgating rules of construction. Wesko Plating, Inc. v. Department of Revenue, 222 Ill. App. 3d 422, 425 (1st Dist. 1991). Subsection (h) of the Department's rule provides a list of income that is not exempt from tax, and subsection (h)(4) indicates that ERISA does not pre-empt the UBIT. The reference does not make the tax solely applicable to ERISA plans, and it is not the type of impermissible "reference to" ERISA plans that would result in pre-emption.

In determining whether the law has "connections with" ERISA plans, the objectives of the ERISA statute must be considered, as well as the effect of the state law on ERISA plans. Dillingham, *supra* at 325. The purpose of ERISA is to avoid inconsistent state and local regulation in order to allow the nationally uniform administration of employee benefit plans. Travelers, *supra* at 657. ERISA controls the administration of benefit plans by imposing reporting and disclosure mandates, participation and vesting requirements, funding standards, and fiduciary responsibilities for plan administrators. *Id*. at 651.

The UBIT is a statute of general applicability that does not have specific connections with ERISA plans. As the court indicated in Travelers, connections are found when the state law imposes a burden on an ERISA plan that effectively functions as a regulation of the ERISA plan itself. If the state law produces such an effect as to force the plan to adopt a scheme of substantive coverage or restrict its choice of insurers, then the state law may be pre-empted. See Travelers, *supra* at 668.

The taxpayer claims that the UBIT imposes reporting and compliance requirements, along with filing and payment duties. The taxpayer has not shown, however, how these additional duties are different than what it does for purposes of filing its federal tax return. The taxpayer has not provided any information concerning additional costs that are imposed upon it as a result of these duties.

The taxpayer also contends that the law impacts its investment strategies. The UBIT does not, however, bind the taxpayer to a particular investment choice. The statute does not dictate how plan administrators must act, and it does not restrict the choice of investments. The UBIT may have an indirect effect on ERISA plans, but it does not rise to the level of regulating ERISA plans that would warrant pre-emption. Unlike Shaw, *supra*, FMC, *supra*, Egelhoff, *supra*, and Alessi, *supra*, the Illinois law does not mandate methods for calculating benefits or determining beneficiary status. The statute does not provide alternative methods for the administration of benefits.

Illinois' UBIT is similar to the laws in the cases where the court found that there is no pre-emption. Like the law in Travelers, *supra*, the Illinois law may make certain investment alternatives more attractive, but cost uniformity was not an objective of pre-emption. As in De Buono, *supra*, the law in the present case is one of general applicability that affects all tax-exempt entities. The UBIT may alter incentives concerning investment choices, as in Dillingham, *supra*, but it does not mandate the choices that must be made.

The taxpayer relies on a decision from the New York State Tax Appeals Tribunal, which found New York's UBIT pre-empted by ERISA. See Matter of McKinsey Master Retirement Plan Trust, 2003 WL 21133964 (N.Y. Tax. App. Trib. May 8, 2003). In McKinsey, the court found that New York's UBIT subjected ERISA plans to reporting and compliance requirements on a state-by-state basis and gave rise to filing and payment duties that involved estimation and timing issues, all of which militated against the congressional aim of achieving a uniform pension law with minimal administrative burdens. The court found that the UBIT referred to ERISA plans because the organizations subject to the law were defined by reference to those organizations defined under Code §401(a).3 McKinsey, *supra* at 10. The result, the court found, was that unrelated business income of ERISA plans was directly subject to the tax. *Id*. Also, the investment returns of the plan participants were reduced dollar for dollar by the amount of the UBIT paid. The court found this to be contrary to the congressional purposes of maximizing the financial well-being of ERISA plans and fostering uniformity in plan regulation. *Id*. at 10-11.

A contrary result was reached in Hattem, *supra*, where the court found that California's UBIT was not pre-empted by ERISA. The Hattem court determined that the tax did not have a "connection with" ERISA plans because it was one of general applicability and did not force trust fiduciaries to act in a certain manner. Hattem, *supra* at 431-432. The court also found that the law did not "refer to" ERISA plans because the

3 Code §401(a) defines qualified pension, profit-sharing, and stock bonus plans. See 26 U.S.C. §401(a).

law did not single out ERISA plans.4 The court stated that the law was broadly crafted and deemed some income taxable while other income remained tax-exempt. *Id*. at 433. The court found that the law functioned irrespective of the existence of ERISA plans, did not relate to the essence of ERISA plans, and did not disturb the uniformity of benefits law. *Id*. at 434.

The Hattem decision is well-reasoned and convincing, and the analysis in Hattem is more persuasive than the analysis in McKinsey. The Hattem court followed the Supreme Court precedent (see e.g., Dillingham, *supra*.), and its analysis applies equally to the present case. The UBIT does not expressly refer to ERISA plans and applies regardless of the existence of an ERISA plan. The UBIT does not have a connection with plans such that it dictates the choices that plan administrators must make. It does not bind ERISA plans to anything. The UBIT is, therefore, not pre-empted by ERISA.

Recommendation:

For the foregoing reasons, it is recommended that the Department's determination be upheld and the taxpayer's requests for refunds be denied.

Linda Olivero
Administrative Law Judge

Enter: July 13, 2006

4 The court noted that the California UBIT statute at issue stated that it applied to any trust that was exempt from taxation by Cal. Rev. & Tax. §17631, and §17631 was the provision that actually referred to Code §401(a). This distinction, however, is not material.